IN THE

Supreme Court of the United States

OCTOBER TERM, 1978

No. 74-1474

DOUGLAS P. FIELDS and ALAN E. SANDBERG,

Petitioners,

v.

UNITED STATES OF AMERICA,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

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PETITIONERS' REPLY BRIEF

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PETITIONERS' REPLY BRIEF

The government's typical, back-of-the-hand style of opposition brief cannot diminish the importance of the legal issues raised by this petition. As to the facts: the government, like the Court of Appeals majority, has bowdlerized the shocking findings of the district court and has otherwise mistreated of the record.*

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* This is, of course, not the place for a lengthy counterstatement of facts. We therefore respectfully urge the Court to compare Judge Haight's painstaking, and undisturbed, findings with the highly expurgated, and inaccurate, version of the facts in the government's submission.

I

In an effort to narrow the Second Circuit's sweeping decision, the government (Br. p. 9) characterizes it as holding that "improper activity" by a corporate officer is "material" because it bears upon the "integrity of management." That characterization only highlights the need for review by this Court, and at this time.

The rubric, "integrity of management," is an utterly limitless test of "materiality" that has been the SEC's standard for wreaking enormous susbtantive changes in the securities laws. Under that banner, a body of statutes designed as a set of disclosure requirements has been transformed, for example, into an ethical code for corporate executives, prohibiting (before any Congressional legislation on the subject) foreign "questionable" payments, "perks," and other conduct deemed objectionable by the SEC or its staff.*

This new, evolving federal code of corporate ethics may well be salutory. But the legal community, and now an SEC Commissioner as well, have become increasingly disturbed because (a) this code is being "enacted" by SEC expansion of the securities laws far beyond their jurisdictional frontiers as established by Congress; and (b) this expansion of law has been, and is being, effected without

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* *See generally* R. Karmel, "Management Fraud—What are the Standards?" (Address, Annual Cooperative Securities Regulation Seminar) (October 27, 1978).

judicial review—largely through consent decrees entered into by the SEC with hundreds of public corporations.*

We submit that this important issue—whether, and when, the notion of "integrity of management" can render corporate or personal conduct "material"—warrants consideration by this Court now, before an all-embracing view of SEC disclosure becomes entrenched national law through continued default or acquiescence. This case, moreover, in its present procedural posture, is an especially appropriate vehicle for consideration of the issue: the contrasting opinions of the courts below put the issue in sharp relief. The district court, in finding no materiality, focused on the absence of injury to—or even effect upon—the corporation (A 48-49, 52-53); the circuit court, in finding materiality, focused instead on the possibility that defendants "may well" have engaged in improper or unlawful conduct (A 100-104).

In these circumstances, the government's arguments (Br. pp. 7-8) concerning the procedural status of the case ring hollow. This Court—in this very term—has not hesitated to grant *certiorari* where, as here, a case posed a significant legal question, even though the appeal was in some sense "interlocutory." For example, in *Broadcast Music, Inc.* v. *CBS, Inc.*, 47 U.S.L.W. 4359 (April 17, 1979), the Court reviewed a determination of the Court of Appeals, after that panel, on a certification, had reinstated the complaint and remanded the cause to the dis-

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* *See e.g.*, R. Karmel, *supra;* Report of the Advisory Committee on Corporate Disclosure to the Securities & Exchange Commission, House Comm. on Interstate and Foreign Commerce, 318-19 (Nov. 3, 1977); Kripke, *Where Are We on Securities Disclosure After the Advisory Committee Report,* 6 *Sec. Reg. L. J.* 99 (1978); Klein, *A Response on SEC Consents—'Process is Corrupting All'*, LEGAL TIMES OF WASH., June 26, 1978, at 21; Werner, *Management, Stock Market and Corporate Reform: Berle and Means Reconsidered,* 77 *Col. L. Rev.* 388 (1977).

trict court for further proceedings. And in *Herbert* v. *Lando,* 47 U.S.L.W. 4401 (April 18, 1979), this Court reviewed a decision of the Court of Appeals on an issue that was brought to the Court of Appeals by certification—in the midst of pre-trial discovery. Denial of *certiorari* in *Herbert*—just as the government says of this case (Br. p. 8)—might well have resulted in a "mooting" of the issue, had plaintiff subsequently prevailed at trial.

And the possibility that the "materiality" issue might be mooted after a trial here is a reason for *granting certiorari,* not denying it. As noted above, the widespread concern of the bar about the "integrity of management" standard stems in part from the fact that that oft consented-to test has not come, and is not likely to come, under judicial scrutiny.

In short, this case is ripe for review by this Court.

II

The government argues (Br. p. 8) that the Second Circuit's decision on "materiality" does not warrant review because it is correct.

Since the government talks about the charge in somewhat abstract terms, let us recall precisely what is and is not alleged to be the crime in this case.

The government (Br. p. 9) contends that in April and May, 1971, defendants "cheated" fifteen TDA stockholders (the so-called "ERD kickbacks") by refusing to "free-up" their restricted stock, engineering its sale to a third party, and receiving a portion of the proceeds.*

* The government (Br. p. 9) appears to suggest that petitioners received some $435,000. In fact, the indictment alleges that in the relevant period petitioners received some $25,000. (Jt. App. in the Ct. Appeals at 21) (The Second Circuit used a figure of $300,000, apparently to characterize petitioners alleged overall expected profit from the transactions. A 83, 102.)

But that alleged "cheating" is *not* the crime with which defendants are charged in the indictment; that crime, if it were a crime, was barred by the statute of limitations. Rather, petitioners are charged with failing to *disclose* their asserted April 1971 impropriety in a November 1971 *TDA* prospectus and a December 1971 *TDA* proxy statement.

The Second Circuit held that these ERD transactions were "material," and were required to be disclosed in TDA's filings, because they "may well" have been unlawful as a violation of Section 16(b). The government (Br. p. 9) rephrases this standard to say that the ERD transactions were "material" *to TDA's* filings because (a) petitioners were engaged in improper conduct and that impropriety reflected on the integrity of TDA's management; and (b) the alleged impropriety could have exposed TDA to private litigation.

Neither of the government's two formulations cures the analytic defects described in the petition.

At the time of the relevant SEC filings—*i.e.,* in November and December, 1971—petitioners were not convicted of, charged with, or even sued on the alleged wrongdoing of "committing" the ERD transactions. In fact, they continue vigorously to deny that their conduct was improper. Hence, under the government's "integrity of management" theory of materiality, petitioners were still compelled to draw a legal conclusion they dispute and then, on that basis alone, to disclose that conclusion, or the facts forming the basis for that conclusion, in later SEC filings. The government's interpretation of the Second Circuit's decision still would require "confessionals of mismanagement past and contemplated." *Limmer* v. *General Telephone & Electronics,* CCH Fed. Sec. L. Rep. ¶96,111 at 92,003 (S.D.N.Y. 1977).

The government's "integrity of management" test also is far too sweeping, and would bring within the ambit of

the securities laws *any* allegedly wrongful conduct, whether it be a violation of some federal (or even foreign) statute or state law doctrines of waste or breach of fiduciary duty. SEC Commissioner Karmel has correctly identified the problem with the scope of the "integrity of management" test:

> . . ., I am troubled by the sometimes articulated theory that any illegal act by management is necessarily material to an evaluation of that management's integrity, and therefore the failure to disclose such information violates the anti-fraud provisions. In particular, I am troubled by the notion that the SEC should be generally investigating suspected violations of federal or state laws other than the securities laws in order to compel disclosure by management of such other violations. Now that, of course, does not constitute an acceptance of corporate crime as a way of business. But corporations are subject to a myriad of federal and state laws, many of which are known to be honored in their breach. *If the SEC could investigate and compel disclosure of any business crime under a management integrity theory, the Commission could well have license to prosecute any public corporation in America.* R. Karmel, "Management Fraud—what are the Standards?" (Address, Annual Cooperative Securities Regulation Seminar) (October 27, 1978) at 17; emphasis added.

The decision below, even as now construed by the government, would accomplish precisely what Commissioner Karmel fears: it would license the prosecution of *any* business crime under the aegis of the securities laws —and that license would nullify all existing criminal statutes of limitation, tolling them until the corporate officer's last SEC filing.

The government's second asserted basis of materiality fares no better. To say, as the government does, that the ERD transactions were required to be disclosed, before there was any litigation on the subject, because they posed a risk of private suits for TDA is absurd because, as one court said, it would impose a "duty to disclose . . . not yet existent litigation." *Shapiro* v. *Belmont Industries, Inc.*, 438 F. Supp. 284, 292 (E.D. Pa. 1977). Under such a theory, for example, management would have a duty to "disclose" that it has engaged in transactions that *might*, some day in the future, be deemed an antitrust violation and *might* thereby someday expose the company to treble damage liability. Again, this theory would embrace nearly all asserted wrongdoing and extend the statute of limitations on an antitrust offense, for example, from four years to the date of an officer's last SEC filing.

Perhaps the best proof that the decision below is wrong —and confoundedly wrong—on the issue of materiality lies in this fact: The Second Circuit said that the ERD transactions were "material" to TDA because they created a potential *asset* for the company (the proceeds of defendants' alleged misdeeds "may well be immediately recoverable by TDA". (A. 102)) The government now says those transactions were "material" because they created a potential *liability* for TDA (potential TDA investors "certainly would have wanted to consider the future adverse consequences to the corporation of petitioners misdeeds . . . the Company . . . [was] expose[d] to large civil liabilities." (Br. p. 9))

Only an utterly unworkable and illogical standard of "materiality" could engender such contradictions.

III

The government ignores the fact that unlawful SEC criminal references have become widespread. It argues (Br. p. 12), instead, that the statutory framework permitting

the SEC to transmit evidence to the Attorney General (not to an assistant United States Attorney, as was done here), is a grant of authority to the SEC rather than a limitation on the powers of the United States Attorneys. The government wholly misconstrues the legislative framework. The pertinent statutes are a limitation on the power of the SEC to disclose *confidential* information derived in the course of a *private* investigation, and, quite properly, are intended to protect those who are the objects of an investigation. 15 U.S.C. §§77t(b) and 78u(e) (1975).

The government's reliance (Br. p. 12) on *United States* v. *Caceres,* 47 U.S.L.W. 4349 (April 2, 1979), is misplaced. The dispositive difference between *Caceres* and this case is that here the SEC violated an explicit statutory directive limiting its authority. In *Caceres,* the Court was careful to note, only a ministerial internal regulation of the agency was involved. 47 U.S.L.W. at 4352.

IV

On the issue of the government's misconduct: The government (Br. pp. 12-13) seeks to minimize the conflict between this case and *United States* v. *Rodman,* 519 F.2d 1058 (1st Cir. 1975) by urging, as it urged below, that the express agreement in *Rodman* and the prejudice occasioned by Mr. Rodman's self-incriminating statements are sufficient grounds of distinction. Petitioners still fail to comprehend how it is more egregious for the government to breach a contract (as in *Rodman*) than fraudulently to induce a contract (as was the case here). Further, the government in *Rodman* had stipulated not to use Mr. Rodman's incriminating testimony; thus there was no "prejudice." The distinctions which the government seeks to urge upon this Court have no basis in the facts or in law, and are made no more tenable by their repetition.

The government (Br. pp. 14-15) urges also that it was proper for the Court of Appeals not to "exercise a chancellor's foot veto over law enforcement practices of which it did not approve." But this is hardly the case for recalling that quotation from *Hampton* v. *United States,* 425 U.S. 484, 490 (1976). The district court here found that there was egregious government misconduct and that there was not available *any* effective remedy for such misconduct other than dismissal of the indictment.* Basic principles of fairness sometimes require a court to dismiss an indictment, Justice Cardozo said, because the constable has blundered. Here, the constable did not merely blunder; he acted wilfully and outrageously. Surely the district court had the discretion in these circumstances to dismiss the indictment.

* The government (Br. p. 5, fn. 5) tries to suggest that the misconduct was remedied: it suggests that the SEC cleaned house because the two SEC staff members who committed the fraud upon petitioners have "since resigned their positions with the government." In fact, one of those staff members left the SEC amicably, after a normal stint with the government, to join a prestigious firm, and *before* this case arose. The second, also after a normal stint with the government, left the SEC to form a law firm last year, and he was regaled with a farewell party by the staff. It appears that neither was ever censured or criticized by the SEC.

Petitioners respectfully urge that their petition for a writ of *certiorari* be granted.

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Respectfully submitted,

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